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ABSTRACT

The Reagan Administration's proposals concerning the Guaranteed Student Loan (GSL) Program and possible alternatives are examined. A variety of proposals are analyzed in terms of the estimated cost savings and potential effects on the supply of and demand for student loans. Background is also included on the history of legislative changes and causes of growth in the program. The Reagan Administration's recommended reforms for GSL, which closely follow President Carter's final budget proposals, would: eliminate the in-school interest subsidy on all new loans, limit eligibility for the new less subsidized loans to the amount of a borrower's demonstrated financial need, and change a market rate of interest for the recently authorized parent loan option under the program. The Administration intends these changes to affect loans made on or after July 1, 1981. It is suggested that while the Administration's intent is to reduce the amount of subsidy and bar the well-off from borrowing under the program, the effect is likely to be more far-reaching on both the supply and demand for student loans. The danger is that student loans would be drastically curtailed for the needy as well as the non-needy. It is claimed that large-scale, short-term cost reductions cannot be achieved without seriously disrupting the plans and decisions of both students and schools, and that the focus of reform should be on achieving effective, longer-term cost controls. Most strategies for controlling GSL costs fall into one of four categories: make GSL less attractive to borrowers, restrict student eligibility for loans, reduce the rate of return to lenders, and limit the volume of lending. It is suggested that an index of need that determines both the borrower eligibility and permissible loan is the most direct and reasonable way to control program costs and reduce excessive borrowing. (SW)

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# The Guaranteed Student Loan Program: Options for Controlling Federal Costs While Preserving Needed Credit for College

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# PREFACE

Approximately three million postsecondary students now borrow through the Guaranteed Student Loan Program. The dramatic expansion of this program since 1978 has altered patterns of financing higher education, for both families and colleges and universities.

Now, in the drive to reduce the national budget, the program faces an uncertain future. The loans are made primarily by banks, but are guaranteed and substantially subsidized by the federal government. Direct federal costs have jumped to well over $2 billion annually and could exceed $3.5 billion next year if the eligibility requirements and terms of the loans were to remain unchanged. The Reagan Administration, however, has proposed major alterations.

Congress must decide how quickly reforms are to be put in place and how much money must be saved in the near term. The task is complicated by the fact that the program operates as an entitlement and most federal expenses associated with it are dictated by obligations on loans made in prior years.

The challenge is to refocus student loan policy and curb federal costs without jeopardizing the program's essential function as a source of credit for students who need it.

This paper examines the Reagan Administration's proposals and focuses attention on alternatives that may be more workable. It analyzes a variety of proposals in terms of the estimated cost savings and potential effects on the supply of and demand for student loans. Background is also included on the history of legislative changes and causes of growth in the program.

Arthur Hauptman, a consultant to the Washington Office, drafted most of the paper. William Van Dusen contributed expertise on the issue of need analysis. Robert Hartman of the Brookings Institution, officials of the Department of Education, and Congressional staff provided helpful comments and criticisms.

The Washington Office of the College Board conducts research on public policy issues in postsecondary education. Results are shared with the membership of the College Board, federal and state policymakers, and other researchers. Grants from the Ford Foundation have enabled the Office to build and maintain an independent capability for policy analysis.

The work presented in this discussion paper, however, does not reflect a policy or position of the College Board, nor any endorsement by the Ford Foundation.

Lawrence E. Gladieux
Executive Director

## THE PROGRAM

The Guaranteed Student Loan Program (GSL) has become a principal means for helping students and their families meet the rising costs of higher education. The explosive growth of this program during recent years, however, has also made it a prime target in efforts to cut the federal budget.

The loans are made primarily by commercial banks but are guaranteed against default by the federal government in conjunction with state agencies. Students enrolled at least half-time may borrow at below market rates of interest (7 percent prior to January 1, 1981, 9 percent for new borrowers thereafter), and repayment of principal does not begin until the borrower leaves school. Loan limits are $2,500 a year for undergraduates and $5,000 annually for graduate students. The government pays the interest during the school years and for a short grace period afterwards. In addition, lenders receive a federal payment, "a special allowance," to compensate for the difference between the statutorily set interest rate and market rates of return.

## THE ISSUE

Since 1978, when students from all income levels became equally eligible to receive subsidized loans, lending has jumped from $2 billion to a possible $7 billion in the current year. Approximately three million students are now borrowing under the program. As loan volume has shot up, so have federal expenses associated with the program--the in-school interest payments, special allowances to the banks, and default (plus death and disability) claims. Costs have more than tripled in three years and are likely to reach $2.5 billion in fiscal year (FY) 1981. If the program were allowed to continue unchanged, lending volume in fiscal year 1982 would probably exceed $9 billion, and federal costs might reach $3.5 billion.

Over the past dozen years a series of legislative changes designed to maintain GSL as a reliable source of student credit has helped to fuel the increase in loan volume and federal costs. High rates of default--especially during the mid-1970s--have also increased program expenses. Recently, the greatest budgetary drain has been soaring market interest rates, which translate into larger special allowance payments to lenders. Of the $1.7 billion growth in annual GSL expenditures between fiscal year 1978 and fiscal year 1981, almost half is attributable to the increased cost of money during that time. (See Appendix A for a historical review of the growth of GSL volume and costs.)

Current GSL policy--interest-free loans to all borrowers while in school regardless of their own or their family's financial circumstances--is under attack. The major policy questions boil down to these:

- Which students, if any, should be eligible for the in-school interest subsidy?
- How much should students or their families be eligible to borrow at below market rates of interest? In particular, should parents be able to substitute low-interest loans of convenience for what they are reasonably expected to contribute to their children's education?

## THE REAGAN PROPOSALS

The Reagan Administration's recommended reforms for GSL, which closely follow President Carter's final budget proposals, would:

- Eliminate the in-school interest subsidy on all new loans.
- Limit eligibility for the new, less subsidized loans to the amount of a borrower's demonstrated financial need.
- Charge a market rate of interest for the recently authorized parent loan option under the program.

The Administration intends these changes to affect loans made on or after July 1, 1981.

In addition, the Reagan plan would require Sallie Mae to shift entirely to private sources of capital sooner than planned under current legislation. This government-sponsored private corporation, which serves as a secondary market for the purchase and exchange of student loan notes, currently relies on borrowing through the U.S. Treasury to finance its operations.

If fully accepted by Congress and implemented on the proposed schedule, the Reagan plan would save the federal government a great deal of money. Although estimates vary, program costs in fiscal year 1982 could drop by as much as $1 billion below what would be spent under current law and regulations. Future savings would be still larger.

While the Administration's intent is to reduce the amount of subsidy and bar the well-off from borrowing under the program, the effect is likely to be more far-reaching on both the supply and demand for student loans. No one can be sure whether or to what degree lenders will stop making loans if, as may happen under the proposed reforms, the paperwork increases and the average loan size decreases, thereby increasing the administrative costs per dollar loaned. Likewise, no one knows how many potential borrowers may be unable to handle the burden of paying interest while in school or to manage the additional repayment obligation if compounded interest is allowed to accrue during the school years.

The danger is that student loans would be drastically curtailed for the needy as well as the non-needy. All told, GSL volume would probably decline by more than half in fiscal 1982 under the Administration's plan, from the current annual level of roughly $7 billion. The Reagan proposals, moreover, come at a time when the National Direct Student Loan Program (NDSL) faces a substantial cutback in Congressional appropriations and the new parent loan plan has not yet (except in one or two states) gotten off the ground. Thus, students and their families cut off from GSL may not be able to fall back on alternative loan sources.

## THE NECESSITY OF REFORM

Continued, open-ended expansion of GSL at highly subsidized rates is unlikely given the current budgetary and political climate in Washington. Moreover, unless checked, the growth of GSL spending threatens to pose budgetary trade-offs that could blunt federal efforts to equalize educational opportunity. While most federal student assistance is subject to annual appropriations review and control, the GSL program is structured as an entitlement: the government is contractually obligated to make certain payments to lenders on each and every loan. The danger is that mandatory GSL expenses will squeeze other, need-tested student assistance programs in the search for what surely will be scarce federal dollars.

If the Administration's proposals would have unacceptable consequences for the millions of students and the hundreds of colleges and universities that now depend on GSL proceeds, the higher education community must be prepared to offer other options for bringing federal student loan costs under control.

## THE TIMING OF REFORM: SHORT-TERM VERSUS LONG-TERM BUDGET SAVINGS

Policymakers must now decide how quickly reforms are to be put in place and how much money must be saved in the near term. Their task is complicated by the fact that currently over 80 percent of annual federal GSL costs are dictated by obligations on loans made in prior years and are largely non-discretionary.

To save money in the current fiscal year and to maximize budget savings in fiscal 1982 (beginning next October 1), the Administration wants its reform proposals to take effect in time to trim lending this summer, when GSL volume is traditionally heaviest as students arrange loans for the fall term. A July 1 rather than an October 1 implementation date could make a difference of $200 million in fiscal 1982 savings.

Past experience, however, suggests that such an early timetable would risk chaos in program operations. In 1972, legislation was enacted that would have required a needs test for some students to receive a GSL. The legislation was signed in late June, effective for loans beginning July 1. Lending virtually halted that summer as banks and government officials wrangled over how to implement the requirement. Emergency legislation had to be enacted in August to permit the resumption of normal lending activity before the school year began; the needs test provision subsequently was permanently dropped.

Regardless of the precise date of implementation, the reality is that large-scale, short-term cost reductions cannot be achieved without seriously disrupting the plans and decisions of both students and institutions of higher education. The focus of reform should be on achieving effective, longer-term cost controls.

## CHOOSING AMONG COST-CUTTING ALTERNATIVES

Most strategies for controlling GSL costs fall into one of four categories:

1) Make GSL less attractive to borrowers.
2) Restrict student eligibility for loans.
3) Reduce the rate of return to lenders.
4) Limit the volume of lending.

The first two aim primarily to shrink unnecessary or excessive student demand for loans (though they might simultaneously lessen banks' willingness to lend). The latter two would reduce the incentives and opportunities for lending, thereby affecting the supply of loans. (See Appendices B and C for a fuller discussion of various cost-cutting alternatives and the estimated savings that would result from them.)

The Reagan plan invokes two types of measures for reducing student GSL demand--it would make GSL less attractive to borrowers by eliminating the interest-free feature on all new loans and it would limit eligibility on the basis of need. As noted earlier, however, the unintended effect would likely be to prevent many needy as well as non-needy students from borrowing.

Instead of this double-barrelled approach, either eliminating the in-school interest subsidy or limiting eligibility for subsidized loans would alone be sufficient to cure the problem of unnecessary borrowing. The cost savings, while not as large as the Reagan cuts, would still be substantial, especially over the long term. Either reduces annual spending by an estimated $300 million in fiscal 1982 and by more than $1.5 billion in fiscal year 1984.

Of the two, ending the in-school interest-free feature is the less attractive or desirable alternative. The in-school subsidy is the one essential element of GSL that remains intact from the original 1965 legislation. Tempting as it may be to abandon such an expensive feature of the program, the drawback is that the neediest students would be the most hard-pressed to make interest payments during their school years or least able to handle the increased indebtedness if the interest is deferred, compounded, and added to the repayment obligation. Moreover, if banks decide to reduce their GSL participation because of the additional paperwork associated with ending the interest subsidy, they are likely to allocate what loans they do make to their best (and wealthiest) customers. Students who are less well-off may be squeezed out of the program completely.

Stretching out the repayment period for borrowers with high debt levels and assuring alternative loan sources might ameliorate, but would not totally offset, the adverse consequences of ending the GSL interest-free feature for needy students.

Restricting Eligibility on the Basis of Need

To control costs over the long term and bar potential abuse in the program, the most direct remedy is to limit eligibility.

One way of defining eligibility is by family income, as was done before 1978. The advantage of an income ceiling is that it is easily understood and simple to administer. But an income cap that allows no gradations is an arbitrary and imprecise proxy for need. Borrowers are either eligible or ineligible for the maximum subsidized loan depending on whether their family income falls above or below the ceiling. An income cap also overlooks a family's other financial resources or constraints, and it fails to recognize the variability in institutional costs.

In addition, a major flaw of a single income cap applicable to all borrowers is that it permits virtually all students who claim to be financially independent of their parents to qualify for the subsidy regardless of what other resources they might have available.

Another way to limit eligibility is to require an analysis of need which compares the student's cost of attendance to a systematic estimate of financial resources available to the student and his family. For GSL, an index of need could be used simply to identify eligible students (as in the case of an income ceiling); or it might also be used to measure the amount that a student could borrow. If need is used only to identify eligible borrowers, it suffers from the same weaknesses as an income cap (except that it would be more sensitive to other financial resources and constraints and would serve as a better screening device for independent students). But if students or families can borrow only to the extent of their need, then the GSL subsidy can be effectively targeted.

There are several arguments against requiring a need calculation to determine the amount of a student's eligibility for GSL. First, to the extent that a needs test would require additional paperwork, it may reduce lender participation. The experience with the 1972 legislation strongly suggests that banks will resist performing any type of need analysis. Second, many banks may be unwilling to lend to students with relatively small amounts of need (of less than $1,000 or so) because of the slim profitability associated with small loans. Finally, limiting a student's loan amount on the basis of need conflicts with a major function that GSL has come to serve: enabling families to substitute all or part of a loan for what they might reasonably be expected to contribute.

These concerns, however, are not insurmountable. For a needs test to work in GSL:

- There must be sufficient lead time to implement it properly and the educational institution--not the bank--should be responsible for providing the estimate of need, based on the cost of attendance and the calculation of financial resources available to the student.

- Threshold loan limits should be introduced. For example, students with less than $200 of need might be ineligible for a subsidized loan while those with need of between $200 and $1,000 might be judged eligible to borrow up to $1,000.

- The GSL need calculation should be less complex and less stringent than prevailing need analysis standards, and the need-based GSL should be accompanied by a much less subsidized but viable parent loan option (see next section).

An index of need for GSL that is both fair and simple might be constructed according to the following specifications:

- To be simpler than other need analysis procedures while recognizing legitimate differences in financial strength, the GSL eligibility index might take into consideration a family's income, size, and the number of children in college, but leave out non-taxable sources of income and the value of family assets.

- To avoid duplication, there should be multiple means for implementing the need analysis requirement. Many students who have filled out forms for purposes of scholarship and other aid programs will already have the necessary information on file with the campus financial aid office. Other students might be permitted to submit the first page of an appropriate income tax form together with the loan application for purposes of verification.

- In determining the amount of need, all other forms of student assistance--including student-related Social Security payments and veterans' educational benefits--should be considered as financial resources available to the student.

(For a fuller description of a possible index of borrower eligibility based on need, see Appendix D.)

Ensuring a Viable Parent Loan Program

Student borrowing based on need should be backed up by a viable parental loan option for families lacking the cash-flow to cover their expected contribution. With the anticipated decrease in student GSL borrowing that will accompany reform, it becomes even more important to ensure that (less subsidized) loans are available to parents (as well as independent students who find themselves unable to borrow on the basis of their need).

Under the Reagan plan, parents who wish to borrow to replace part or all of their expected family contribution would only be able to do so at market rates of interest, instead of the 9 percent rate enacted in the 1980 Amendments, and no special allowance would be paid to the lender. In all likelihood, this proposed change will effectively kill chances of getting the parent loan program

off the ground nationwide. Lenders appear reluctant to participate without a government payment that assures a yield linked to changes over time in general interest rate levels.

Alternatively, if the interest rate for parental loans were raised to 12 or 14 percent and the special allowance (albeit smaller than on the student loans) continued, the current potential for "arbitrage" by parental borrowers would be curtailed without unduly deterring lenders from participating in the new program.

## Regulating Supply

While the Reagan plan is mute on the issue of lender incentives and opportunities in GSL, a balanced set of reforms might include measures to reduce the supply of GSL as well as reducing borrower demand. For example, it may prove desirable to moderate the yield to lenders by altering the special allowance payment formula or perhaps gearing the formula to an index of profitability such as size of a lender's student loan portfolio.

It may also be advisable to consider placing a limit on the amount of loans guaranteed and subsidized by the government in any given year, thereby providing a backstop should other policy reforms fail to result in sufficient reductions in lending activity and program costs. Limiting the volume of GSL lending, however, would alter the entitlement nature of GSL. More important, determining which states, which lenders, and which students would have access to the limited federal guarantees and subsidies would introduce considerable complexity and uncertainty into the administration of the program.

## SUMMARY

The alternatives discussed here would not achieve savings of the magnitude called for by the Administration. But the growth of the Guaranteed Student Loan program would be brought under control and the long-term burden on the federal budget significantly reduced without undercutting necessary program operations.

An index of need that determines both borrower eligibility and permissible loan amounts is the most direct and reasonable way to control program costs and reduce excessive borrowing. The eligibility calculation should reflect the significant and real differences in the ability of families to pay for their children's education, yet be simple enough not to encumber the administrative machinery of the program. Such a test should also recognize that tuition levels among institutions of higher education do vary and that a legitimate function of guaranteed loans is to enable students who choose

higher cost institutions to pay for that choice out of future earnings. Annual estimated savings resulting from applying an index of need--even a relatively lenient calculation--would still exceed $1 billion annually by fiscal year 1984.

Raising the interest rate for parental loans to 12 or 14 percent should help to ensure that this new option is not abused, while still providing an alternative source of funds for parents who lack the cash-flow to cover what they might reasonably be expected to contribute to their children's education. Additional long-term savings might be achieved by further increases (to perhaps 10 or 11 percent) in the interest rate charged to student borrowers, elimination of some of the current provisions that allow students in specified circumstances to defer repayment of their loans, and modification in the special allowance formula that governs the rate of return to lenders.

Reform of the Guaranteed Student Loan program must be perceived as fair to borrower, lender, and taxpayer alike. The challenge now is to ensure that changes are reasonable and workable--to refocus the program and curb federal costs without jeopardizing the important function of GSL as a source of credit for students who need it.

APPENDIX A

WHY HAS GSL GROWN?

Under current law and regulations (and assuming only a modest reduction of interest rates over the next year), federal expenditures for GSL in fiscal year 1981 will be approximately $2.5 billion,* and the figure in fiscal year 1982 could exceed $3.5 billion, compared to $700 million as recently as fiscal year 1978.

The growth of federal outlays has accompanied an enormous expansion in the annual volume of GSL lending. If current policies remain in force, over $7 billion of loans will probably be made in fiscal year 1981, a threefold increase in just three years, and lending may reach $9-$10 billion in fiscal year 1982. This trend ensures additional future expenditures since every dollar of new lending commits a string of federal payments stretching over a number of years.

Commitments on loans made in prior years, in fact, represent most of the present annual federal costs of GSL. Of the $2.5 billion in estimated expenditures during fiscal year 1981, approximately 80 percent--$2 billion--can be traced to loans made before the beginning of the current year. If no loans were made at all during fiscal year 1982, expenditures next year would still reach almost $3 billion.

There are three principal components of federal costs associated with GSL borrowing:

a) While a borrower remains in school and for a short "grace period" thereafter, the federal government pays to the lender the interest on behalf of the student borrower.

b) The federal government also pays to the lender a "special allowance" each quarter to compensate for the difference between the statutorily-set interest rate charged to borrowers and a market rate of return; the payment is based on the total dollar value of student loans held by a lender.

c) Lenders are guaranteed for both principal and interest in the case of death, disability, default, or bankruptcy of the borrower. This guarantee is generally a two-step arrangement in which state-authorized agencies enter into agreements with lenders, and the federal government then reinsures the state guarantee agencies, usually at 100 percent of the defaulted amount.

*The official Administration figures are substantially lower, but seem to be based on unrealistically low estimates of interest rates and of outstanding loans on which subsidies must be paid. The Congressional Budget Office (CBO) estimate for GSL current policy expenditures in fiscal year 1981 is approximately $2.5 billion.

The following table shows how expenditures for these three components have grown and are projected to grow.

GSL Obligations (in millions of dollars)

| | Fiscal Years | | | | | |
|---|---|---|---|---|---|---|
| | 1970 | 1975 | 1978 | 1980 | 1981 (estimated) | 1982 (projected)* |
| "In-School" Interest | $103 | $230 | $249 | $ 445 | $ 665 | $1,100 |
| Special Allowance | 9 | 87 | 195 | 820 | 1,460 | 1,800 |
| Guarantee** | 5 | 120 | 226 | 279 | 300 | 400 |
| Total*** | $117 | $437 | $670 | $1,544 | $2,425 | $3,300 |

*Estimates of expenditures under current law. All other figures from Federal Budget Appendix or Department of Education.

**Federal expenditures for claims for death, disability, default, or bankruptcy of borrower, net of federal collections on defaulted loans.

***This total is slightly lower than total GSL costs, which also include expenses for collections, computers, and administrative allowances to guarantee agencies and educational institutions. These "other" costs are approximately $50 million in fiscal year 1981.

The growth in GSL has several principal causes: a series of legislative changes over the past dozen years designed to maintain GSL as a viable source of student credit; the unprecedented level of interest rates in the economy; and well-publicized problems in the rate of default by student borrowers.

Legislative Changes

Congress first authorized GSL in 1965 as part of the Higher Education Act to provide incentives to private lenders to make loans of convenience, primarily to students from middle-class families. Federal costs, it was assumed, would be minimal: borrowers with family income below $15,000 would qualify for the in-school interest subsidy and the federal government would guarantee the lender against borrower default.

Since initial passage, the legislation has been altered to: ensure an adequate rate of return to lenders, make more students eligible for the in-school subsidy, provide greater incentives for states to establish guarantee agencies, and gear permissible loan amounts to the rising costs of going to college.

The first substantive changes came in 1968. When market interest rates began to rise above historical levels, Congress increased the interest charged to student borrowers from 6 to 7 percent. It also created a shared federal/state responsibility for the guarantee of loans: in states that established a guarantee agency, the federal government would cover 80 percent of the default cost and states were to be responsible for the remaining 20 percent. Where no state agency existed, the federal government would continue to insure lenders directly at 100 percent of the claim.

In the next year, as market rates continued to rise, Congress provided for a special allowance to be paid by the government, not the borrower. Under this plan, each lender would receive a payment based on the dollar value of all student loans not yet repaid; the amount of the special allowance each quarter was to be set by a committee of government officials, but was not to exceed 3 percent (on an annual basis) of the value of the lender's student loan portfolio.

The Education Amendments of 1972 created the Student Loan Marketing Association (Sallie Mae)--a private corporation--and authorized it to borrow under federal auspices. By allowing lenders to sell or borrow against their student loan paper, Sallie Mae was intended to encourage participation by lenders who otherwise might be reluctant to make student loans because of their relatively low yield and long duration.

Also included in the 1972 Amendments was a requirement that students must demonstrate financial need before receiving a GSL. However, confusion about which students were subject to this needs requirement and insufficient time to prepare for its implementation led to a virtual halt in GSL lending during the summer of 1972. In order to permit resumption of normal lending activity, emergency legislation to suspend these provisions was enacted in August 1972, and they were later permanently dropped.

In 1976, the income ceiling under which families could qualify for the federal in-school interest subsidy was raised from $15,000 to $25,000* in recognition of the increase in the average income of parents sending their children to college.

The 1976 Amendments also provided greater incentives for states to establish guarantee agencies, based on evidence of lower default rates on loans made under state auspices. These incentives apparently worked; almost all states now have a guarantee agency and over 90 percent of all new GSL lending is now initially guaranteed by a state-authorized agency, compared to 60 percent in fiscal year 1976.

Finally, the 1976 legislation made the special allowance more responsive to changes in market interest rates by tying it automatically to quarterly changes in the rate for 91-day Treasury bills. The formula that was adopted

*Income as defined for GSL eligibility made allowance for differences in family size and certain expenditures. For a family of four, the GSL income ceiling of $25,000 translated into about $31,000 of adjusted gross income, as defined in the tax code.

provides for a total return to lenders (that is, student interest rate plus special allowance) of the Treasury bill rate plus 3.5 percent. In addition, the 3 percent cap on the special allowance was raised to 5 percent.

Probably the most far-reaching change, however, occurred in 1978 when the Middle Income Student Assistance Act (MISAA), in addition to changing eligibility for the Basic Grant program, also totally removed the income ceiling in GSL.

Elimination of the income ceiling has had several major effects which help to explain why GSL volume has jumped so remarkably in the past few years. Most obviously, a new group of students became eligible for subsidized loans, and there are indications that increasing numbers of high-income students and families are availing themselves of the opportunity.

Note On Who Is Borrowing

Since the passage of the Middle Income Student Assistance Act of 1978 and the elimination of the income ceiling for determining GSL eligibility, systematic information on the income of borrowers and their families is no longer available. The Virginia Education Loan Authority, however, is one agency that continues to collect family income data on its loan application form. The Virginia data show that borrowing at all income levels has increased substantially since MISAA, more than doubling in each income group. The expansion of subsidized loans since MISAA has obviously benefitted many who were previously ineligible for the program (that is, their family income was above the $25,000 cut-off). At the same time, it has benefitted many lower-income families, presumably satisfying a considerable pent-up demand that could not be met under the conditions that prevailed before 1978.

The greatest proportionate increase in GSL borrowing, however, seems to have been in the higher-income brackets. In 1979, the first year after MISAA, less than 10 percent of the Virginia borrowers indicated family income above $40,000; the figure rose to 20 percent in 1980. The upward trend between 1979 and 1980 suggests that the well-to-do are becoming increasingly aware of their newly established eligibility for student loans. Growing publicity about the program and increased investment consciousness during a time of continued high inflation and high interest rates appear to be spurring the trend.

But removal of the income ceiling has had other effects as well. It has allowed banks to drop the previous system of double bookkeeping for subsidized and unsubsidized loans. Perhaps as important, the dynamics of the GSL application process have changed since students can now walk into a bank and apply for a loan without their parents being asked to provide financial information. Each of these factors has contributed to the growth of GSL lending activity since 1978.

In 1979, to reflect the skyrocketing interest rates in the economy and to encourage lenders to remain in the program, the lid on the special allowance payments was lifted entirely. Expanding the special allowance has stimulated lenders to increase supply sufficiently to keep up with borrower demand, which has burgeoned as rising interest rates make the fixed-rate GSL more attractive.

In passing the Education Amendments of 1980 after protracted debate, Congress responded to pressures to curb GSL costs by raising the interest rate charged to new borrowers to 9 percent and shortening the grace period before the borrower begins repayment to six months. It also halved the amount of the special allowance on loans funded directly by state agencies that use revenue bond proceeds. This last change addressed the problem of arbitrage, which had permitted some states to reap substantial windfalls at federal expense because of the difference between the market rates of return they receive on GSL and their low cost of raising funds through tax-exempt bonds.

In recognition of the continuing increases in college costs, the 1980 Amendments also raised the cumulative amounts that students could borrow in GSL. For undergraduates, the maximum was raised to $12,500 from the previous $10,000 limit, and total GSL borrowing limits for graduate/professional students are now $25,000, up from the previous $15,000. Annual GSL limits remained unchanged: $2,500 for undergraduates and $5,000 for graduate or professional school students. In addition, separate limits were newly established for undergraduate students who are independent of parental support--$3,000 per year up to $15,000 cumulatively.

The 1980 Amendments also authorize a GSL option in which parents of dependent, undergraduate students can now borrow up to $3,000 per year ($15,000 total) to help in the financing of their children's undergraduate costs. The interest rate for these loans is pegged at 9 percent--the same as the student borrower rate--but repayment commences within 60 days of disbursement. Thus, no in-school subsidy is available to parental borrowers. However, as with student loans, the federal government would pay a special allowance to assure the lender a market rate of return.

Finally, the 1980 legislation envisioned a much larger role for Sallie Mae in the collection and consolidation of loans from various sources, and in raising capital for state guarantee agencies. It also extended Sallie Mae's authority to borrow from the U.S. Treasury through the end of fiscal year 1984.

In addition to legislative changes, increases in interest rates and student default rates have also contributed heavily to GSL costs.

Interest Rates

Since special allowance payments to lenders are now automatically tied to the 91-day Treasury bill rate, when market interest rates rise so do the obligations of the federal government. With unprecedented high levels of interest, special allowance payments have soared.

In fiscal year 1981, special allowance payments will approach $1.5 billion, an increase of about $1.3 billion from fiscal year 1978. Total GSL expenditures have grown by $1.7 billion during this same time period. If interest rates, instead of soaring far into the double-digit range, had remained at 1978 levels (when the Treasury bill rate averaged 7 percent), special allowance payments in fiscal year 1981 would be approximately $800 million lower than presently estimated. Thus, almost half of the growth in GSL expenditures in recent years ($800 million of $1.7 billion) can be linked to the increase in market interest rates and its effect on GSL special allowance payments.

Defaults

During the mid-1970's, the growth in GSL costs was fueled by the astounding increase in the number of borrowers who defaulted on their repayment obligations; the default rate climbed well above 10 percent of all borrowers entering repayment. Concerns about the default rate led to a set of remedies, including expansion of the corps of government collection agents, greater use of outside collection agencies, eligibility restrictions for institutions with abnormally high default rates, and a heavier reliance on state guarantee agencies (which appear to have better record of collections than the federal government).

These efforts have, in recent years, resulted in reduced concern about GSL defaults. Expenditures for defaults have shown only moderate growth, as indicated in the table on page 2. However, the Administration's fiscal year 1982 budget estimates that default claims in fiscal year 1982 will nearly double over fiscal year 1981 levels and that claims related to death and disability will increase eightfold. These estimates of growth in default-related claims derive mostly from the Administration's assumption that parental borrowing will blossom to over $2 billion by fiscal year 1982. (Parental loans are assumed to be subject to much higher death and disability claims than student loans for obvious age-related reasons; defaults should occur more quickly because repayment begins immediately after disbursement.)

The Administration's prediction of parental loan volume, however, appears overly high (especially if parents are to be charged a market rate of interest), and the default-related estimates are, as a consequence, probably overstated. If, on the other hand, the Administration's estimates prove accurate, control of default costs may again become a major public and Congressional concern.

# APPENDIX B

## A DISCUSSION OF COST-CUTTING ALTERNATIVES

Congress, in debating the Administration's and other proposals to reduce GSL costs, will want to consider the impact of these alternatives on lenders, students, and educational institutions.

What will happen to the supply of loans and what is the banks' tolerance for change? Student loans represent only a small portion of the investment portfolio of most banks and it is possible that additional paperwork or less profitability will lead to a mass exodus of lenders from GSL. Many of the past legislative changes in GSL have been in response to threats by lenders that they were about to pull out of the program. Policymakers must also be cognizant that small banks will have a different set of concerns from large lending institutions.

If loan volume is reduced, which present borrowers will be unable to borrow? Equity considerations suggest that to the extent that GSL is subsidized, available loans should be targeted on students who need the funds. But many lenders, if forced to cut back, may well choose to give first priority to families who are their best customers. And determination of need can be a tricky business--is a middle-class student attending an expensive private college more or less needy than a poor youngster going to the local community college? Proposals may vary widely in their effects on students at high- and low-cost institutions.

Proposals may also be compared in terms of the short- and longer-range cost savings that would be achieved; the timing of cost reductions will vary among proposals. Some of the most reasonable and cost-effective proposals may show little savings until five to ten years from now. How important is it to achieve large cost reductions in the next year?

Alternatives should further be evaluated on the basis of their administrative feasibility. Some past efforts to reform GSL, such as the proposed requirement of a needs test in 1972, failed because insufficient attention was paid to how the plan could best be implemented. Care must be taken in designing a plan that is workable. Otherwise, the entire GSL program could come to a halt, as it did in 1972.

Finally, if policymakers are bent on proposals which could dramatically reduce GSL volume, they must also consider what alternative sources of lending might be available for students and their families. Two loan sources are of particular importance. One is the National Direct Student Loan (NDSL) program, which since 1958 has provided federal funds to educational institutions for the purpose of making low-interest loans to needy students. NDSL default rates, however, are substantially higher than in GSL, and current budget stringency limits the growth potential of NDSL, which depends on direct annual appropriations. Although the 1980 Amendments did authorize alternative NDSL financing through federal borrowing, the proposed crackdown on federal credit activity greatly diminishes the likelihood that this borrowing authority will be utilized at least in the next few years.

The other potential major loan source is the parental loan program authorized in the Education Amendments of 1980. But parental loans are untested. While some states are beginning to establish the basis for a parental program, realistic expectations suggest only modest growth at least for the next year or two. Growth prospects are further limited if interest rates charged to parents are set at market levels, as proposed by the Administration. At present, most states are proceeding very cautiously in setting up parental loan programs because of their uncertainty about future federal policy in this area.

Most of the GSL cost-cutting alternatives presently being suggested by the Administration, the Congress, or other groups fall into one of the following categories: 1) Make GSL less attractive to borrowers; 2) Restrict student eligibility for loans; 3) Reduce the GSL rate of return to lenders; and 4) Limit the volume of GSL lending. The first two categories are aimed primarily at reducing unnecessary or excessive borrower demand for loans (although they might also reduce banks' willingness to lend.) The latter two would reduce the opportunities and incentives for lending, thereby affecting the supply of GSLs. These types of cuts can be made either separately or in combination. Each alternative has drawbacks which should be considered in developing a GSL cost-cutting package.

1) Make GSL less attractive to borrowers. Potential borrowers may be discouraged from applying for a GSL by: raising the interest rate charged to borrowers; shortening the "grace period" after the borrower leaves school but before repayment begins; altering the provisions for the in-school interest subsidy; or eliminating existing deferment provisions.

The 1980 Amendments moved in this direction by increasing the interest rate and shortening the grace period. Some suggest that the interest rate should be further increased to, say, 10 percent. Others would make the interest rate vary with market conditions--for example, charge student borrowers the current Treasury bill rate minus one or two percentage points. Changing the interest rate, however, results in very little cost savings in the next several years--less than $50 million annually--unless the in-school subsidy provisions are changed as well. (Whatever change is made in the rate charged to the borrower, the combined government obligation for in-school and special allowance payments would be the same while the borrower remains in school.)

Instead of lifting interest rates, the Reagan proposal would eliminate the in-school interest subsidy for all new loans. Banks and borrowers would be left to negotiate whether in-school interest would be paid on a current basis or "capitalized" (that is, allowed to accrue and added to the principal of the loan). This proposal would reduce federal fiscal year 1982 costs by at least $300 million below current projections, and annual savings in fiscal 1984 would mount to $1.6 billion.

The in-school subsidy, however, is the one feature of GSL that remains intact and unaltered from the original 1965 legislation. Before 1978, when there was an income cap on borrowers who could qualify for the in-school

subsidy, lenders were reluctant to make loans which would require billing students individually for their interest obligations while in school. Such loans represented less than 5 percent of total borrowing at that time.

The option of capitalizing the in-school interest would probably not satisfy the cash-flow needs of many lenders, especially small banks. A solution that addresses this cash-flow concern would be for the government to continue providing lenders with interest payments while the borrower was in school, then have the lender reimburse the government for these in-school interest payments, once the borrower's repayment period began. Cost savings to the federal government over the next several years, however, would be essentially erased.

Also, many students may be hard-pressed to make interest payments during the school years, and if the interest is deferred, compounded, and added to the repayment obligation, the resulting levels of increased indebtedness could be excessively burdensome for some students. Some observers, in fact, believe that what the government saves by increasing the freight on the student borrower may be offset by increased default rates down the road.

One other method for reducing the attractiveness of GSL borrowing should also be mentioned. The GSL legislation permits borrowers who enter into specified types of activities after leaving school--such as military service or certain types of teaching assignments--to defer beginning repayment of their loan, usually for periods up to two or three years. During the deferment period, the federal government continues to make in-school interest and special allowance payments. The 1980 Amendments added to the list of activities qualifying for deferment, provided for a grace period after deferment, and allowed borrowers under the parental option to defer their GSL obligations in selected instances.

Some of these deferments now appear outmoded or unwarranted. (For example, why should parental borrowers be able to defer their repayment commitments?) While eliminating all of the existing deferment provisions would save less than $50 million annually, these implicit subsidies should at least be scrutinized as to their effectiveness, and modified or eliminated where appropriate.

2) Restrict student eligibility for loans. Two principal ways for limiting GSL eligiblity are reinstitution of an income ceiling, or a requirement that students and their families must demonstrate financial need to qualify for a loan.

If an income cap were reimposed at $40,000, costs in fiscal year 1982 would be reduced by approximately $150 million, and by fiscal year 1984 the annual cost savings might be $900 million. Annual GSL volume might be reduced by 20-30 percent below current projections.

The advantage of an income cap is that it is easily understood and apparently not difficult to administer, based on the pre-1978 experience. On the minus side, an income cap is an arbitrary and imprecise proxy for need;

it allows for no gradation in assessing the relative amount needed by different potential borrowers. For this reason, students at high-cost institutions might be particularly disadvantaged by reinstitution of an income cap. An income cap is also not an effective cost containment tool for dealing with one of the realities of higher education today--the growing proportion of students who are financially independent of their parents. Almost all independent students--probably constituting at least one-third of the present GSL borrower population--would qualify for a loan on the basis of their income regardless of other measures of need.

Under the Administration's proposal, eligibility for student loans would effectively be limited to the amount of a student's financial need, defined as cost of attendance minus financial resources available to the student (including the family's expected contribution and other assistance). The government would pay a special allowance only on the amount loaned for which need could be demonstrated.

This proposal would substantially reduce GSL activity for several reasons. With no special allowance, banks would presumably be unwilling to lend to non-needy students. Needy students, while eligible, would often not receive as much as they do now. And students with a limited amount of need--less than $1,000 or so--might find banks reluctant to make such small loans. The lender's fixed costs per transaction could make small loans nonprofitable.

Successful implementation of a needs test in GSL would require avoidance of the pitfalls that occurred in 1972. Namely, there must be sufficient lead time and educational institutions--not banks--must do the need calculations.

The savings resulting from a needs test, however, could be substantial, since it appears that at least one-third of current GSL borrowers would probably not qualify on the basis of need. If these students were no longer eligible, costs in fiscal year 1982 would be reduced by as much as $300 million, and fiscal year 1984 costs would fall by $1.5 billion. If, in addition, some present GSL banks decide to lend less because of increased paperwork or dwindling profit margins, savings would be even greater.

It has also been suggested that the income cap and need analysis proposals could be combined. For example, students with family income of less than say, $25,000, could be automatically eligible for the in-school interest provisions while students with family incomes above the cap could qualify for subsidized loans to the extent of their documented need. Such a proposal would produce savings of $200 million in fiscal year 1982 and $1 billion by fiscal year 1984. Under such a plan, however, the issue of how to consider the needs of independent students remains troublesome.

3) Reduce the GSL rate of return to lenders. The primary means for reducing the return for GSL lenders is to reduce the special allowance. Since the notion of linking the special allowance to the Treasury bill rate has gained general acceptance, the way to cut the allowance is to reduce the amount provided by the formula. Presently, the total return to lenders--the student

interest rate plus the special allowance--is pegged at the Treasury bill rate plus 3.5 percent. If, for example, the formula were reduced by one percentage point, federal expenditures in fiscal year 1982 would be $200 million less, and savings in fiscal year 1982 would be $350 million.

There can be little doubt that establishment and augmentation of the special allowance over the years has been a crucial element in keeping lenders involved in GSL. Most lenders further assert that the present cost of money implies an extremely narrow yield on their GSL investments and that any diminution in the special allowance would lead to their withdrawal from the program. However, there remains the question of how large the special allowance needs to be to ensure adequate lender participation. In the past two years, in a period of extreme credit tightness and with a multitude of attractive investment opportunities available throughout the economy, GSL lending has doubled.

But assessing the margin of GSL profitability is a complex issue. Cost of money and administrative expenses may vary widely for lenders according to their size, geographic location, tax status, and other characteristics. Small banks in largely rural states often have a lower cost of money than the big lending institutions in New York City. But their administrative costs per loan may be higher. If the most important factor in predicting profitability could be determined, it might then be possible to provide a differentiated special allowance. For example, if the evidence suggests that profitability is most closely related to the size of a bank's student loan holdings, then the special allowance formula could be geared to this factor, with the highest percentage paid for the first student loan dollars in the portfolio. The difficulty here, of course, is reaching agreement on the index of profitability.

The Reagan proposal does not alter the amount of the special allowance per dollar loaned. However, it does eliminate entirely the special allowance for loans to non-needy students and for loans to parents.

4) Limit the volume of GSL lending. A direct method for limiting GSL volume would be to impose a ceiling on the amount of new loans each year that are guaranteed by the federal government, thus removing GSL from the ranks of federal entitlement programs. Through an allocation process, lenders would be notified of the annual number and/or amount of loans which would be guaranteed against default, or for which subsidies would be paid. If the volume of future lending, for example, were limited to the current level of $7 billion, fiscal 1982 expenditures would be reduced by a modest $150 million. But cost savings over the next five years would be substantial relative to present projections--$1.1 billion annually by fiscal 1984.

Devising an equitable allocation scheme, however, might prove to be an extraordinarily difficult task. Of equal concern is the method by which lenders decided who could borrow. The likelihood is that under such a plan

new loans would be tilted toward higher income students and families (the better credit risks and the banks' regular customers), unless an income-related criterion or needs test was simultaneously imposed.

Another means for limiting GSL is to reduce the amount that a student can borrow, either annually or cumulatively. But cutting back on loan limits saves very little money.

The Reagan proposal presents a more indirect way of limiting overall GSL activity by abruptly ending (much earlier than called for by the Education Amendments of 1980) Sallie Mae's authority to borrow through the U.S. Treasury. At least in the short run, Sallie Mae is not likely to be able to raise as much money in the private capital market as through the Treasury. To the extent that many lenders have come to rely on Sallie Mae as a ready source of liquidity for their GSL portfolio, a truncated Sallie Mae would eventually reduce lender participation in GSL.

APPENDIX C

## ESTIMATED ANNUAL SAVINGS FROM COST-CUTTING ALTERNATIVES

The following table summarizes the estimated cost savings that would result from the various alternatives discussed in the preceding section. These are College Board estimates and may be at some variance with estimates of the Administration, Congressional Budget Office, or other organizations and individuals.

(in millions of dollars)

| | FY 82 | FY 84 |
|---|---|---|
| Current Policy | $3,300 | $5,000 |
| Reagan Proposal | 800 | 2,300 |
| Alternatives | | |
| Raise interest rate of new loans to 10 percent | * | 100 |
| Eliminate in-school interest subsidy on new loans | 300 | 1,650 |
| Place $40,000 income ceiling on eligibility for in-school subsidy | 150 | 900 |
| Limit subsidized loans to "remaining" financial need | 300 | 1,550 |
| Place $25,000 income cap on automatic eligibility for in-school subsidy; students with higher incomes could qualify on basis of need | 200 | 1,000 |
| Reduce special allowance payment formula by one percentage point | 200 | 350 |
| Limit guarantee authority to FY 81 lending level | 150 | 1,150 |

*Less than $50 million

In considering these figures, please note that:

1) The cost savings associated with the various alternatives are not additive, as there is overlap in the populations affected by these proposals.

2) These estimates do not fully include the possible impact of lenders withdrawing from GSL because of the cumulative burden of these additional restrictions.

3) The estimates provided here assume a gradual reduction in market interest rates (approximately one percentage point per year) and a modest increase in the volume of lending under current law ($1 billion additional lending in each succeeding year). Alternative interest rate or lending assumptions may have significant impact on the current policy projections or the dollar value of savings resulting from these various alternatives.

4) Implementation is assumed to begin on October 1, 1981. An earlier date would result in greater savings than indicated here.

# APPENDIX D

## CONSTRUCTING AN INDEX OF BORROWER ELIGIBILITY

If eligibility for subsidized Guaranteed Student Loans is to be restricted according to financial need, the following approach might be considered.

The first part of the calculation would be to estimate family ability to pay based on these steps:

1. Determine the student's dependency status and whose income will be considered in the determination of eligibility. The standard test of dependency status, used for other federal programs, would be applied to GSL eligibility determinations.

2. Determine adjusted gross income from the appropriate tax form. Non-taxable income from sources like public assistance, child support, pensions, Social Security, etc., would not be included in this determination.

3. Deduct a "family size offset," based on the Bureau of Labor Statistics low or perhaps moderate budget standard, and include in this offset estimated average federal, state, and local taxes.

4. Multiply the remainder by an appropriate "taxing" rate to be determined as a matter of further public discussion.

5. If more than one family member is attending a postsecondary educational institution that charges tuition and fees, divide the resulting amount equally.

The procedures described above generally follow those incorporated in other need analysis methods but differ in some significant ways, reflecting an assumption that the needs test for a guaranteed loan should be somewhat simpler and more flexible than for more heavily subsidized forms of aid such as Pell Grants or even National Direct Student Loans.

Non-taxable income is not included in this approach, creating a possible "loophole" through which high-income families who have been able to invest in various forms of non-taxable income-producing assets would benefit. However, information about non-taxable income is among the most difficult to collect, verify, and interpret. Elimination of routine consideration of this income source would benefit a few wealthy families; it would also reduce unnecessary intrusion into the financial circumstances of many more low-income families. Some critics of the current process claim that this intrusion is a major factor in the lower-than-expected participation of low-income students in postsecondary education and student aid programs.

When the campus financial aid administrator "signs-off" on the student borrower's eligibility (see procedure described below), there would be an opportunity for consideration of non-taxable income if, in the judgment of the aid administrator, it was of a sufficient level to warrant exclusion from program eligibility.

The proposed approach does not routinely make allowance for other items of family expense considered by prevailing need analysis methods, such as the employment expenses of families where both parents work, unusual medical and dental expenses, casualty losses, etc. This omission is another attempt to reduce the complexity of data collection, analysis, and interpretation. Again, the campus aid administrator could be permitted to make exceptions, providing a "safety valve" for families with substantial expenses in these (or other) areas to receive additional consideration.

Another major exception to the established methodologies is the total exclusion of family assets from determination of their ability to pay. The methodologies exclude some forms of assets from consideration (residence equity, automobiles, life insurance cash value, boats, airplanes, etc.) and then reduce the remaining assets by some measure of "asset protection." The approach suggested here for purposes of GSL eligibility "protects" all family assets from consideration.

The methodologies used to determine eligibility for other forms of aid use family size offsets to reflect the normal, ongoing expenses that must be met in the course of living and maintaining a household. These offsets are based on various "budget standards" promulgated by the Bureau of Labor Statistics (BLS), the Department of Agriculture, or the Social Security Administration, to reflect the typical living patterns of different segments of the American population. The so-called Uniform Methodology uses the BLS "low budget" standard. For determining GSL eligibility, the BLS moderate standard might be appropriate.

Remaining family income would be "taxed" at a percentage rate or set of rates, as in other need analysis systems, to determine the estimate of family ability to pay. Since there is little inherent economic rationale to suggest that one percentage rate is more appropriate than another, whatever rate or rates are deemed appropriate for use in other programs might be used for purposes of GSL eligibility as well. Different rates for dependent and independent students might also be considered.

Having determined the family's GSL index of ability to pay, the maximum loan eligibility could be determined according to the following procedures:

1. Determine the total cost of attendance

2. Deduct the family's GSL index of ability to pay

3. Deduct existing student aid (Pell Grant, state, campus-based, and private), expected student term-time employment income, and payments of Social Security and veterans' benefits.

The remainder, subject to statutory limitations on GSL borrowing, would be the family's maximum loan eligibility.

If the GSL index of eligiblity can be kept sufficiently simple, it might be possible to permit self-calculation by applicants through a "table-lookup" similar to that used in the federal income tax procedures, or through straightforward instructions calling for exact values and the full methodology. Sample tables could be made a part of GSL program promotional materials. Statements on how the family should calculate its index might simulate those of the IRS Form 1040.

Because the proposed estimate of maximum loan eligibility would take into account the actual cost of attendance and the aid available from other sources, it would require a review and certification by the campus aid administrator. "Verification" of the GSL index of family ability to pay could be performed as part of that process. For the 4.5 million students who submit regular need analysis documents to the Pell Grant or private agency processors, the GSL index would have been calculated already. For others a copy of the first page of the appropriate tax form could be submitted together with the loan application for purposes of verification. This procedure would permit easy "entry" into the system, possibly through self-calculation, while assuring sufficient oversight through verification to discourage abuse.

As noted earlier, the campus aid officer should be given reasonable discretion to adjust loan eligibility up or down to reflect significant circumstances not adequately dealt with in the procedures described above.

Admittedly, the index of need suggested here is more complicated than a simple "income ceiling" or cut-off for eligibility. It would, however, result in more equitable determinations of eligibility than would an arbitrary income ceiling. For great numbers of applicants it would "piggy-back" on the routine aid eligibility determination processes currently in use for other programs with no additional requirement for data collection from students or families. It would provide an easy, relatively unintrusive method for those not currently submitting need analysis documents to calculate and demonstrate their ability to pay for purposes of GSL determination. And it would meet the criteria of equity and fairness to the borrower, the lender, and the taxpayer that should characterize any modification of the current program and procedures.